City of Houston, Texas

Report to Management for the
Year Ended June 30, 2004

CITY OF HOUSTON, TEXAS

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December 23, 2004

The Honorable Mayor, Members of
City Council and City Controller
of the City of Houston, Texas

In planning and performing our audit of the basic financial statements of the City of Houston, Texas (the "City") for the year ended June 30, 2004 (on which we have issued our report dated December 23, 2004), we considered its internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the City's internal control. However, we noted certain matters involving the City's internal control and its operation that we consider to be a reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the City's internal control that, in our judgment, could adversely affect the City's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions we noted are described below.

GRANTS FUNDS WITHIN THE HOUSING AND COMMUNITY DEVELOPMENT DEPARTMENT

Finding: A number of significant audit adjustments related to the Housing and Community Development Department ("HCDD") notes receivable grant funds were required to be recorded during the 2004 audit for various items, including the following:

- Notes receivable balances that were recorded on the general ledger of the City had not been evaluated and written down to their appropriate balance a of year-end resulting in a material write-down of such balances;
- Some notes receivables that should have been reflected on the City's general ledger were not included on the books of the City, which resulted in such notes receivables having to be added to the general ledger for financial reporting purposes.
- It did not appear that the HCCD loan servicing division and the HCCD accounting division regularly communicated related to the status of notes receivable balances.

Recommendation: HCCD should investigate balances that are, or should be, reflected in the general ledger of the City to ensure that such balances are properly represented for financial reporting purposes.

PROPERTY

Finding: The City's accounting for property transactions does not appear to be a coordinated effort which has led to material adjustments being made during the annual audit process. We noted instances in which property balances were not reconciled to the appropriate property subledgers and property transactions were not properly reflected in the City's general ledger system.

Recommendation: The City should perform a critical review of the information flowing in and out of the various subledger systems and evaluate how this information should be reconciled to the general ledger of the City.

Our consideration of the City's internal control would not necessarily disclose all matters in the City's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. None of the reportable conditions described above are believed to be material weaknesses.

We also submit our comments concerning certain observations and recommendations relating to other accounting, administrative, and operating matters. These recommendations resulted from our observations made in connection with our audit of the City's financial statements for the year ended June 30, 2004. Our comments are presented in Exhibit II and are listed in the table of contents thereto.

This report is intended solely for the information and use of the Mayor, City Council, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

We will be pleased to discuss these comments with you and, if desired, to assist you in implementing them.

Yours truly,

Deloitte & Touche LLP

EXHIBIT I

REPORTABLE CONDITIONS

A. GRANTS FUNDS WITHIN THE HOUSING AND COMMUNITY DEVELOPMENT DEPARTMENT

Finding: A number of significant audit adjustments related to the Housing and Community Development Department ("HCDD") notes receivable grant funds were required to be recorded during the 2004 audit for various items, including the following:

- Notes receivable balances that were recorded on the general ledger of the City had not been evaluated and written down to their appropriate balance a of year-end resulting in a material write-down of such balances;
- Some notes receivables that should have been reflected on the City's general ledger were not included on the books of the City which resulted in such notes receivables having to be added to the general ledger for financial reporting purposes.
- It did not appear that the HCCD loan servicing division and the HCCD accounting division regularly communicated related to the status of notes receivable balances.

Recommendation: HCCD should investigate balances that are, or should be, reflected in the general ledger of the City to ensure that such balances are properly represented for financial reporting purposes.

Response: HCDD will regularly investigate balances that are, or should be, reflected in the general ledger of the City to ensure that such balances are properly represented for financial reporting purposes. Every Note Receivable related to Single-Family assistance and Multi-Family projects is in the process of being evaluated for its accuracy and collectibility.

B. PROPERTY

Finding: The City's accounting for property transactions does not appear to be a coordinated effort which has led to material adjustments being made during the annual audit process. We noted instances in which property balances were not reconciled to the appropriate property subledgers and property transactions were not properly reflected in the City's general ledger system.

Recommendation: The City should perform a critical review of the information flowing in an out of the various subledger systems and evaluate how this information should be reconciled to the general ledger of the City.

Response: The City is in the process of converting the City's GFAMS asset system to the AIIMS asset system that is being used by the Public Works & Engineering Department. This will enable departments and high-level users of the application to have better control of reconciling the asset system (subledger) to other subledgers such as CIP and real estate(land) and the General Ledger. The Information Technology project team is developing enhancements for implementation to the application to comply with the required reporting standards as established by the City Controller's Office to meet all Consolidated Annual Financial Report requirements.

Additionally, the City is in the process of completing an Enterprise Resource Planning Project that will enable the City to create and control all asset entries with automated business processes to create GL data through the integrated subledgers. The ERP Project will replace the City's current financial, purchasing, asset, human resources and general ledger systems.

EXHIBIT II

OTHER ACCOUNTING; ADMINISTRATIVE AND OPERATING MATTERS

A. CASH

Finding: A number of significant audit adjustments related to cash were required to be recorded during the 2004 audit due to certain reconciling items on the June 30, 2004 bank reconciliation not being recorded in the correct period as described below:

- Deposits that cleared the bank in June 2004 but were not recorded in the general ledger until July 2004
- Cash disbursements that were made in July 2004 either issued as a check or wire transfer were recorded in the general ledger as June 2004 transactions
- Cash disbursements that were made in June 2004 and cleared the bank in June 2004 were not recorded in the general ledger until July 2004
- Certain deposits and withdrawals were noted as being recorded to the general ledger twice.

Recommendation: Policies should be put in place that requires departments to record cash transactions in the month in which they occur. Further, as part of the city-wide cash reconciliation, in which the Controller's office consolidates and reviews all departmental reconciliations, any errors noted should be communicated back to the department and either the department or the Controller's office correct the error.

Response: Policies exist requiring that cash receipts received but not posted by June 30th be stamped "Prior Year" and forwarded to the Controller's Output Control Section for processing. The policy is included in the year-end closing procedures. The procedures are distributed and discussed each year with department representatives.

To enhance compliance, the Controller's Bank Reconciliation Section (BRS) will notify departments of any material cash receipts that have been banked by June 30th but have not been booked by the close of accounting period twelve (12). Departments will have two (2) days to prepare the required entry for processing in accounting period thirteen (13). If the department does not comply within the specified two (2) days, the BRS will book the cash in accounting period thirteen (13).

BRS will follow the similar procedures for other reconciling items, such as duplicate bookings of deposits and disbursements. The Controller's Treasury division will be notified of money wires booked in the wrong fiscal year, i.e. banked by June 30th and not booked in accounting period twelve (12). Treasury will take appropriate steps to ensure that the items are booked in accounting period thirteen (13).

B. INVESTMENTS

Finding: The City tracks its investments in Pools at cost and each Fund within the City is designated to an investment pool. Investment pools are allocated monthly to each Fund based on each respective Fund's cash transactions. As the City maintains its investments at cost, an adjustment at year-end is required to properly state investments at market. Market value is determined at the pool level and each fund should be adjusted to market based on its designated investment pool. During testing we noted certain inconsistencies in the market value adjustment calculation including the following:

- Certain market value adjustments were based on the market value adjustment for pool 960, as pool 960 is the primary operating pool for the City, instead of segregating the investments between all applicable pools and utilizing the market value percentage adjustment for each respective pool.
- An inconsistency exists between how the market value adjustment is being calculated by the investment group and how the market value adjustment is being applied against the equity in pooled cash and investment balance at the fund level. Such market value adjustment as calculated by the investment group is based on the actual investment instrument, excluding cash and accrued interest whereas the equity in pooled cash and investment balances at the fund level includes the allocated portion of cash and accrued interest from the respective pools.

Recommendation: In order to ensure that the investment balance for each fund is recorded accurately, each fund holder should review and reconcile the investment balances by pool to a fund reconciliation report and ensure that each fund holder is calculating the market value adjustment based on the applicable pool's market value percentage adjustment and cash and accrued interest are excluded from the computation.

Response: The City has reevaluated the current process for booking the year-end market value adjustment. The market value adjustment will be based on the investment's actual market value increase or decrease which will be allocated among the pools based on the pool income off the June 30th I400M investment report. This methodology will eliminate the use of percentages and exclude accrued interest and cash.

C. INVENTORY

Finding: The Fire Department did not perform an inventory observation in the prior year resulting in an adjustment of approximately $560,000 to the fleet inventory balance for 2004. We also noted that inventory observations are conducted at different periods during the year and very few of the departments actually perform an inventory count at year-end due to the reliance on the perpetual inventory systems in place.

Recommendation: The City needs to establish additional policies and procedures to ensure that all departments are properly performing their inventory counts and the timing of such counts are conducted at or near year-end.

Response: The Controller's Office has established procedures that will be distributed to all departments requesting that all inventory counts be conducted at or near year-end.

D. CAPITALIZED INTEREST

Finding: Capitalized interest was miscalculated in two of the three enterprise funds tested during the current year, which resulted in material audit adjustments. The miscalculation was due to certain factors not taken into consideration including the date in which substantial assets were complete and the weighting of commercial paper throughout the year versus the year-end balance.

Recommendation: Calculate and record capitalized interest for all enterprise funds in a consistent manner ensuring that all applicable factors are taken into consideration.

Response: The Controller's Office is developing procedures that will help ensure that capitalized interest is calculated and recorded in a consistent manner for all enterprise funds and that all applicable factors are taken into consideration.

E. CAPITAL ASSETS

1. Compilation of Capital Asset Rollforward

Finding: The City's capital assets are recorded in multiple systems including the General Fixed Asset Management System ("GFAMS"), the Asset Information Management System ("AIMS") and offline excel spreadsheets. For purposes of financial reporting, these systems must be combined. During testing, we noted that the compilation of this information was a challenge and required that several drafts be reviewed prior to the creation of a successful rollforward.

Recommendation: The City needs to establish standardized templates which ensures that information is presented in a consistent manner and that the final balances of all systems utilized in the property rollforward equals the sum of the respective systems for all property components.

Response: Standardized templates were developed by the Controller's Office and forwarded to the Finance and Administration and Public Works departments for presenting fixed asset information in a consistent manner. The templates should provide for an accurate rollforward of fixed asset data. Improvements will continue to be made as needed.

2. Reconciliation of Subledger Systems to the General Ledger

Finding: The City recorded several "clean up" entries in 2004 to rectify differences that existed between the subledger systems and the general ledger.

Recommendation: The City should implement additional policies and procedures which will ensure that critical reviews of the information flowing in and out of the subledger systems is accurate and that such subledger systems are reconciled to the general ledger of all funds of the City on a regular basis.

Response: The City is in the process of converting the City's GFAMS asset system to the AIIMS asset system that is being used by the Public Works & Engineering Department. This will enable departments and high-level users of the application to have better control of reconciling the asset system (subledger) to other subledgers such as CIP and real estate (land) and the General Ledger. The Information Technology project team is developing enhancements for implementation to the application to comply with the required reporting standards as established by the City Controller's Office to meet all Consolidated Annual Financial Report requirements.

3. Reconciliation of Capital Outlay to Capital Asset Additions

Finding: The City is required, under the provisions of GASB Statement No. 34, "Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments", ("GASB No. 34"), to make adjusting entries related to capital outlay, which is expensed at a governmental fund level and capitalized at a government – wide level, in order to properly reflect the financial position of the City. The City maintains certain accounts that are to be used to track expenses that relate to capital assets, however, such accounts are not being used exclusively for this purpose, which creates difficulties in reconciling expenses incurred in the current year to additions in capital assets. During fiscal year 2004 the City made great strides in performing and improving this reconciliation process; however certain unreconciled differences still existed in fiscal year 2004.

Recommendation: The City should reevaluate current practices that are being utilized to capture and record capital asset information as compared to capital outlay expenditures.

Response: The City is in the process of converting the City's GFAMS asset system to the AIIMS asset system that is being used by the Public Works & Engineering Department. This will enable departments and high-level users of the application to have better control of reconciling the asset system (subledger) to other subledgers such as CIP and real estate (land) and the General Ledger. The Information Technology project team is developing enhancements for implementation to the application to comply with the required reporting standards as established by the City Controller's Office to meet all Consolidated Annual Financial Report requirements.

Additionally, the City is in the process of completing an Enterprise Resource Planning Project that will enable the City to create and control all asset entries with automated business processes to create GL data through the integrated subledgers. The ERP Project will replace the City's current financial, purchasing, asset, human resources and general ledger systems.

4. Improper Expensing of Capital Assets

Finding: Certain assets, including building costs and other equipment, were not properly reflected as capital assets in the Convention & Entertainment fund, but were expensed, which resulted in certain adjustments to the records of the City for the year ended June 30, 2004.

Background: The City expenses the purchases of capital assets in its enterprise funds and at year-end reverses these expenses to capital asset additions. The City has established accounts to track such purchases that are capital in nature, but the coding associated with these purchases is not being strictly adhered to. We noted instances in which the entire purchase order was being coded to such accounts without taking into consideration that only some of the purchases would qualify for capitalization.

Recommendation: The City should reevaluate current practices that are being utilized to capture and record capital asset information.

Response: Convention & Entertainment is developing procedures that will ensure that capital assets information is captured and recorded accurately and timely.

5. Depreciation

Finding: Testing of depreciation expense identified errors resulting in significant audit adjustments to correct for the overstatement and understatement of depreciation expense. These errors primarily related to capital assets maintained outside the City's main subledger systems – GFAMS and AIMS. For the Houston Airport System fund, we noted that substantially completed assets transferred out of construction-in-progress and assets accrued for as of year-end had not been entered into GFAMS and a separate calculation of depreciation expense had not been performed resulting in an understatement of depreciation expense. For the Combined Utility System fund, we noted that depreciation expense for certain capital assets not entered in AIMS was booked twice resulting in the overstatement of depreciation expense. Depreciation expense for donated water/waste water pipes was properly calculated for donations received during fiscal year 2004, however the depreciation calculation excluded the water/waste water pipe beginning balance resulting in an understatement of depreciation expense. In addition, accumulated depreciation was miscalculated on meters retired resulting in an understatement of the amount of accumulated depreciation removed from the general ledger and an understatement of the loss on disposal.

Recommendation: The City should establish policies and procedures relating to the review of the City's depreciation expense calculation on capital assets maintained outside the City's main subledger systems.

Response: The City has established a procedure that will ensure timely input of assets that are not available for analysis until after the fiscal year end. This procedure will ensue that the assets entered into the Fixed Asset System have the proper depreciation. The AIIMS fixed asset system is currently being modified by the IT Department to incorporate the assets that previously resided on the GFAMS fixed asset system.

6. **Land Reconciliation**

Finding: The City does not have adequate procedures in place to ensure that values recorded for land in GFAMS and AIMS can be reconciled with land data tracked and recorded in the City's Real Estate Department. The Real Estate Department does not always receive sufficient information from other departments to properly record the land transactions and that the general ledger is not being reviewed to ensure that all land transactions have been accounted for resulting in certain land purchases not being picked up by the City's Real Estate Department and adjustment to the financial statements.

Recommendation: The City should ensure that land data tracked and recorded by the City's Real Estate Department is reconciled to the information encompassed in GFAMS and AIMS and that all expense accounts are reviewed to ensure that all capital related transactions are properly captured and accounted for in the capital asset subledger systems and properly recorded at the government-wide level of reporting.

Response: The City has established a procedure with the Real Estate Department to reconcile all transactions in detail. The City's fixed assets will all reside on one system as of June 30, 2005 that will enable uniform reconciliations. Additionally The Real Estate Department has modified their system to provide the necessary reports for balancing.

7. **Donated Assets**

Finding: During fiscal year 2004 the City implemented certain procedures and methodologies to account for donated assets, however, we noted certain issues related to the underlying information upon which the calculation of the donated assets was based which resulted in significant audit adjustments. For the water/waste water pipes, we identified that the underlying data provided by the GIMS system had inadvertently been altered which resulted in an overstatement of donated assets. In addition, we noted the donation amount was based on the operational information contained in the GIMS system (i.e. the date/time in which the infrastructure is added to the City's GIMS system) however, a substantial time lag existed between when the assets were donated and when the information was entered into GIMS system resulting in an understatement of donated assets. For donated streets, the information utilized to base the donation amount was incomplete as it related to acceptance dates, which resulted in an understatement of donated streets.

Recommendation: The City needs to revisit its procedures/methodologies in which donated assets are captured and properly recorded in the general ledger of the City.

Response: The City has established a procedure to reconcile the information received from the GIS system as of the fiscal year end and the subsequent audit date.

8. **Construction-in Progress ("CIP")**

Finding: The Convention and Entertainment fund had certain CIP projects which were substantially complete but which had not been reclassed into the proper capital asset line item. In addition, the Houston Airport System had a large number of substantially completed capital projects reclassed from CIP to the respective capital asset category in fiscal year 2004 which had substantial completion dates prior to fiscal year 2004. By not properly removing projects, which are substantially complete, out of CIP in the year in which the asset is considered substantially complete, the City could overstate capitalized interest and understate depreciation expense.

Recommendation: The City should perform a thorough review of projects classified as CIP and remove those projects that have been placed into service to ensure that depreciation expense and capitalized interest calculations can be properly recorded.

Response: The City has a procedure in place that removes substantially complete projects from WIP and accrues them to the fixed asset category. This accrual enables the asset to properly depreciate from its substantial completion date. The City will ensure that all departments utilize this procedure.

F. ACCOUNTS PAYABLE

Finding: The City made great strides in capturing the liability of services received/rendered for fiscal year 2004, however there were still certain disbursements that qualified as accounts payable for the year ended June 30, 2004 that were not originally captured and recorded as such in the general ledger of the City. In addition, certain liabilities were based on estimates where the estimates were not reconciled to actual costs.

Recommendation: The City should modify its policies related to capturing and recording accounts payable items to ensure that a proper cut-off is achieved at year-end.

Response: The Controller's Office's account payable policy does establish a proper cut-off and is included in the year-end closing procedures that are discussed and distributed each year. A need does exist for continued improvement and the City will increase its efforts to ensure that accruals are properly reflected at year-end.

G. COMPENSATED ABSENCES

Finding: The City's compensated absences compilation reports originally were not calculating the City's compensated absences liability in accordance with the provisions of the compensated absence plan of the City. This resulted in material adjustments to the current year financial statements.

Recommendation: Procedures need to be established and put in place to capture and record compensated absence information properly.

Response: The program that generates the compensated absences report was modified during the audit and the results were tested to ensure that compensated absences were being captured and recorded properly.

H. STALE BALANCES

Finding: The City has made great strides in researching stale balances, however, many balance sheet accounts still exist in which the balances have not changed for over one year.

Recommendation: The City should continue to perform a detailed review and analysis of accounts with stale balances.

Response: The Controller's Office staff continues to work aggressively to analyze and resolve existing accounts with stale balances.

I. ACCRUED PAYROLL

Finding: The City's payroll accrual was understated as of year-ended, resulting in material adjustments to the current year financial statements. The City properly calculated and recorded the payroll accrual based on the last payroll of the year, however the City did not compare the accrual calculation to the final general ledger to determine if ending general ledger balance was stated based on their calculation. Through a review of the accrued payroll accounts, it was noted that certain of the payroll clearing accounts reflected large debit balances. Based on further inquiry, it appeared that the debit balances were a result of cumulative clearing errors of the system among funds.

Recommendation: Clearing accounts need to be reviewed on a monthly basis to ensure that such clearing accounts are properly clearing and the payroll expense properly stated.

Response: The Fundholder for the Payroll Clearing Fund (Fund 956) will be reviewing all payroll liabilities to ensure that they are properly clearing each month. The Controller's office staff is currently analyzing accounts to liquidate prior year payroll liabilities. With these two procedures in place, the payroll expense should be properly stated in the future.

J. DEBT

Finding: The City entered into complex debt transactions during fiscal year 2004. We noted certain errors in the City's calculation and recording of such transactions including 1) refunding gain/loss calculations included accrued interest expense paid at the time of the refunding and 2) the amortization of refunding gain/loss, premium/discounts and issue costs did not take into consideration the amortization period between refundings which resulted in adjustments to the City's schedules.

Recommendation: The City should enhance the review and approval process of debt transactions and journal entries to ensure the proper recording and tracking of such debt transactions.

Response: The Controller's Office has retooled its method of recording gain/loss calculations on refunding debt, including enhancing the review process. The premium, discount, and cost of issuance amortization schedules have been adjusted using the actual day count method to more accurately reflect the periods between the refundings.

K. UNRECONCILED CASH ACCOUNTS

Finding: Certain cash accounts related to the Houston Foundation fund were not reconciled to the bank statements nor were fiscal year 2004 transactions related to this fund recorded in the general ledger resulting in material adjustments in the current year.

Recommendation: All cash accounts of the City need to be monitored and reconciled on a monthly basis to the general ledger of the City to ensure proper recording in the books and records.

Response: The Controller's Office and F&A will work together to ensure that all cash accounts are being properly monitored. Relative to the Houston Foundation, F&A will keep track of all bank statements received on a monthly basis and will prepare JVs at the end of each quarter following the receipt of earnings distribution from the Hill and Bering Trusts and disbursements of funds to charities. The JVs will be posted to the Advantage System and reconciled to the bank statements. The Controller's Office will review and pass the JVs according to the procedures that have been established.

L. WORKING TRIAL BALANCES

1. Standardization of Working Trial Balances

Finding: The City utilizes working trial balances to prepare its Comprehensive Annual Financial Report ("CAFR"). We noted that the format for the working trial balances varied among funds. In addition, certain mathematical errors, formula problems or hard coded numbers where formulas were expected which result in working trial balances not functioning as intended.

Recommendation: One standard working trial balance template needs to be utilized for all funds. Each working trial balance needs to be reviewed for mathematical accuracy.

Response: The Controller's Office will continue to work to standardize the working trial balances (WTBs). New procedures are being implemented to ensure that the WTBs are standardized and to ensure that each supervisor reviews each WTB for mathematical errors and formula issues.

2. Preparation of and Adjustments to Working Trial Balances

Finding: The City prepares its working trial balances based on the period 13 close. Certain improvements were made by the City to record adjustment prior to the period 13 close; however a significant number of adjustments were still required to be posted to the working trial balances.

Recommendation: The City should review its year-end closing process and evaluate the adjustments posted after the period 13 close to determine the cause of such adjustments and if such adjustments can be processed prior to the period 13 close.

Response: The Controller's Office will continue to monitor its year end closing process to ensure necessary adjustments are recognized and recorded prior to the close of period 13 whenever possible. However, given the nature of certain adjustments, there will still be a need for the City to make some period 14 adjustments.

M. CASH FLOW STATEMENTS

Finding: Cash flow statements were initially inaccurate and required significant revisions by the Controller's Office.

Recommendation: The City has a standard cash flow template which should be reviewed for consistency among all funds and training should be provided to employees who are responsible for completing these cash flow statements.

Response: The Controller's Office is developing procedures to ensure that a standardized format and methodology is utilized in preparing the cash flow statements. Training will be provided to all enterprise fundholders on the preparation of these cash flow statements.

N. ACCOUNTS RECEIVABLE AND RELATED ALLOWANCE FOR DOUBTFUL ACCOUNTS

Finding: The City has improved its receivable analysis for certain receivables including ambulance, liens and tax receivable accounts, however the allowance for doubtful accounts for other receivables are determined based on old historical collection data that has been carried forward for several years.

Recommendation: The City should establish policies and procedures for calculating the allowances based upon historical experience taking into consideration collections in recent years.

Response: City departments will be reminded of City of Houston Executive Order # 1-38 Accounts Receivable Policy regarding aging analysis, aged cash receipts and cash collection percentages. The executive order calls for quarterly analysis of aged receivables. Finance & Administration will provide technical assistance to city departments, if needed.

O. JOURNAL ENTRIES

Finding: The City properly prepares and approves journal entries; however, the approval process is not adequately identifying and preventing incorrect journal entries from being posted to the general ledger resulting in a significant number of correcting entries. We noted journal entries in which the debits and credits were listed backwards, account descriptions did not match the account code and amounts posted to incorrect accounts. In addition, we noted instances in which the supporting documentation lacked a clear audit trail in providing evidence or proof in how the amounts were determined.

Recommendation: The City should establish policies and procedures to ensure that those reviewing and approving journal entries are identifying incorrect journal entries and that the supporting documentation adequately supports the amounts and basis for the journal entries.

Response: The Controller's Office is writing procedures related to journal entry preparation and approval. These procedures will be provided to all City Departments and will help ensure that all JVs: 1) have the correct supporting documentation; 2) have the correct account descriptions for the related account codes; 3) include a short explanation of the transaction in the comments section, and; 4) show debits listed before credits. The Controller's Office will discuss these procedures with departmental personnel during the periodic departmental meetings held by the Financial Reporting Division of the Controller's Office.

P. BUSINESS CONTINUITY PLANNING

Finding: The City's disaster recovery plan has been documented. However, the plan has not been tested to ensure that it can be executed in the event of a disaster as no recovery tests have been performed since 1999. In addition, the document is not comprehensive enough to ensure a true business continuity plan.

Recommendation: Perform tests of the City's disaster recovery plan to ensure that it will perform as anticipated in the event of a disaster.

Response: The Department of Information Technology working with the City's Technology Steering Committee, is in the process of obtaining and implementing a citywide Disaster Recovery contract and plan. In the interim of this plan, expedited contract recovery services will be utilized in the event of system outages. In addition to these efforts, a citywide Continuity of Operations Planning (COOP) is currently underway with an anticipated completion date of July 2005.

Q. WINDOWS AUDITING POLICY

Finding: The local audit policy setting has not been activated to record any security event or incident; therefore there are no records of security violations.

Recommendation: Activate the local audit policy setting related to Windows to enhance the capability of detecting and documenting security violations.

Response: The local audit policy is not enabled because domain-level auditing is active. The domain-level policies override the local settings on the machine. Since the computers are members of a domain, the City's System Services Group of the Information Technology Department has set domain-level auditing policies.

R. SYSTEM BACKUP

Finding: Although backup tapes are restored occasionally, there are no formal periodic backup readability tests of the IBM mainframe tapes. The readability of backup tapes is tested incidentally when data needs to be restored. Faulty system and/or data backup tapes may not be detected and unwarranted reliance may be placed on them. Backup tapes may become unreadable hence required data might not be available when needed.

Recommendation: Periodic tests for backup readability should be performed and should include data and system backups. These tests should be performed on a regular basis and should form part of the formal Disaster Recovery Plan.

Response: There are three types of 'System Saves'. System, Test and Production are full volume saves on a weekly, monthly, quarterly and annually. Between the weekly saves there are 'incremental saves' that capture any changed data since the last full save. In creating the initial (Master file) we perform a disk-to-tape operation. In addition we create a second (Copy file) set using a tape-to-tape process. In doing this we actually verify the readability of the Master because it is used as the input for the copy. It is true that the Copy is not verified in the same manner however, our current tape systems do a 'read-after-write' verification any time data is outputted to magnetic tape. This verification is done on the fly for ALL write operations.

PRODUCTION SAVES
In the course of Production job flow (AHR, AFM and Daily) there are specific points at which saves (ADABAS and Ledger for example) are taken for recovery purposes. Although we have never specifically restored these saves as a test, we have never had an occasion where a restore was required (hardware failures) that the information was not readable and the restore was unsuccessful.

GENERAL
In the past, hardware was much more susceptible to failure and restores were more prevalent. With the newer technology, hardware has the capability of recovering and rebuilding damaged data on the fly and transparent to the operating system. Therefore, the necessity of restoring data from tape has been greatly reduced.

Going forward, we will perform periodic samplings of stored media to verify its readability. This would most likely be based on the retention period and the length of time a particular cartridge has been on the shelf.

S. COMPUTER ACCESS RIGHTS

Finding: While Data Owners and Managers determine the segregation of duties of each employee; they do so without following any predetermined process to ensure that appropriate access rights are being assigned. Such absence of standardized processes increases the possibility of compromising the segregation of duties, particularly when someone changes a job functions and/or department.

Recommendation: A standardized and documented approach should be adopted that assists management in ensuring that appropriate segregation of duties is maintained when granting access to new or existing users.

Response: The Administration of the Security for various computer applications is standardized and there are several controls in place to ensure that segregation of responsibility is reviewed prior to granting new access or changing existing user's access. The City will review the procedures in place to ensure compliance with controls established and make any revisions where necessary.

T. APPLICATION SYSTEM IMPLEMENTATION AND MAINTENANCE

1. Development and Testing Methodology

Finding: There are no formal documented procedures that outline the development and testing methodology for the City of Houston's IT department; only migration procedures are documented. Unapproved or erroneous changes could be implemented which could impair the availability, confidentiality and/or integrity of IT based information.

Recommendation: Standardize, document and implement policies and methodologies for the development and testing environment. Good documentation also facilitates the rotation of personnel, separation of duties, and continuity of operations in the event of turnover of key personnel. The policies should incorporate all affected users, including programmers, operators, and end-users.

Programming standards exist to help ensure the consistency of program development or maintenance activities across all programming projects of the organization. This helps achieve a number of objectives within the information systems function, including:

- consistency across programs,
- better cross-functional support,
- shorter learning cycles for new employees, and
- protection against the loss of any particular programmer.

Response: We are in the process of purchasing a new Enterprise Resource Plan (ERP). Development and testing methodology will be an integral part of the ERP development. Currently, we maintain consistency across programs by having designated personnel/programmers check any modifications made to programs and to ensure that appropriate comments and changes are identified clearly.

2. Mainframe Development Environment

Finding: Although a testing and production environment exists for mainframe modifications, there is no development environment. All modifications to IT systems should be developed and tested in an environment that is segregated from the production environment. If changes are developed and tested in the production environment, errors could be introduced to the production environment, systems could fail or act unpredictably. By not having a development environment, there is the risk of not having an appropriate or relevant testing environment that can replicate the production environment and provide an accurate assessment of the future change.

Recommendation: Consider establishing segregated development, testing and production environments, while simultaneously developing methodologies and approval policies to ensure the appropriateness of modifications and/or implementation of new systems.

Response: We do have a segregated development environment but due to the shortage of space, we had to store a limited amount of data in it. Recently, we have acquired a new Mainframe system and a storage facility. We are in the process of creating a complete set of development, testing, and production environments as per the recommendations.

3. Change of Management Policy

Finding: The Change of Management Policy only applies to the COBOL environment and there is no policy for the other applications and systems. Unauthorized or inappropriate changes may be made to the IT environment. The consequences of this include the following:

-- Increased information systems costs
-- Reduced benefit from investment in information systems
-- Duplication of data and systems, with possible reconciliation problems
-- Incompatibility of data and systems
-- Increased support effort
-- Inconsistent, unsatisfactory, or erroneous management reporting.

Recommendation: Develop and document a change of management policy that is applicable to all environments that are used for the operation of the City of Houston.

Response: There is a Change Management Policy for both COBOL and NATURAL programs in the IBM environment. The programmers use NATE application to migrate NATURAL programs from development to production environment. A Manager/Project leader must signoff on all COBOL and NATURAL program migrations. For other program environments and database changes, a Change Management process is in place with a document that outlines the changes, contingencies, risks and requirements, and requires approval from management.

U. DATABASE IMPLEMENTATION AND SUPPORT

Finding: Robert Lee (Systems Consultant) is the only employee that has access to the production environment for the data dictionaries and there is no backup database administrator. Lack of succession planning and cross training can result in over reliance on particular personnel which could have a direct effect on performance and even ongoing viability of the entity.

Recommendation: Succession planning involves the training and provision of staff who can take over the function of another (typically more senior) staff member should they be unable to perform their function. Cross training involves staff learning several job functions so that each may have more variety in their work and can fulfill a backup role for other staff members. The use of either of these techniques will assist greatly in business continuity as loss of critical staff resources and skills can cripple an entity's ability to fulfill ongoing information systems requirements. This skill requirement is particularly critical in the event of a disaster.

Response: The Information Technology Department has primary and backup Database Administrators for all Database environments except the IBM system. The Database group has assigned another Database

Administrator to be the backup for the IBM system. The Database Administrator group is training the backup individual on the IBM system.